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In the Supreme Court of the United States

OCTOBER TERM, 1931

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

HENRY HARMEL

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

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The Solicitor General, on behalf of the petitioner, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Fifth Circuit in the above case entered February 23, 1932 (R. 36), granting a petition to review and reversing the decision of the United States Board of Tax Appeals (R. 18). The opinion of the court below (R. 35) is not yet reported. The opinion of the Board of Tax Appeals (R. 16) is reported in 19 B. T. A. 376. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether cash bonuses paid as advance royalties under oil and gas leases on lands in the State of Texas constitute income from the sale of capital assets within the meaning of Section 208 of the Revenue Act of 1924.

STATUTE INVOLVED

Revenue Act of 1924, c. 234, 43 Stat. 253, 262 (U. S. C., Title 26, Sec. 939):

> SEC. 208. (a) For the purposes of this title—
>
> (1) The term "capital gain" means taxable gain from the sale or exchange of capital assets consummated after December 31, 1921;
>
> (2) The term "capital loss" means deductible loss resulting from the sale or exchange of capital assets;
>
> (3) The term "capital deductions" means such deductions as are allowed by section 214 for the purpose of computing net income, and are properly allocable to or chargeable against capital assets sold or exchanged during the taxable year;
>
> (4) The term "ordinary deductions" means the deductions allowed by section 214 other than capital losses and capital deductions;
>
> (5) The term "capital net gain" means the excess of the total amount of capital gain over the sum of (A) the capital deductions and capital losses, plus (B) the amount,

if any, by which the ordinary deductions exceed the gross income computed without including capital gain;

(6) The term "capital net loss" means the excess of the sum of the capital losses plus the capital deductions over the total amount of capital gain;

(7) The term "ordinary net income" means the net income, computed in accordance with the provisions of this title, after excluding all items of capital gain, capital loss, and capital deductions; and

(8) The term "capital assets" means property held by the taxpayer for more than two years (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale in the course of his trade or business.

(b) In the case of any taxpayer (other than a corporation) who for any taxable year derives a capital net gain, there shall (at the election of the taxpayer) be levied, collected, and paid, in lieu of the taxes imposed by sections 210 and 211 of this title, a tax determined as follows:

A partial tax shall first be computed upon the basis of the ordinary net income at the rates and in the manner provided in sections 210 and 211, and the total tax shall be this amount plus 12½ per centum of the capital net gain.

STATEMENT

The petitioner is an individual residing at Megargel, Texas. In the year 1924 the petitioner was, and had been for many years, the owner in fee simple of certain lands. In October, 1924, he executed two oil and gas leases covering said land on the basis of stipulated royalties and a cash consideration of $57,000. (R. 15.) This cash payment was returned by petitioner as gain from sales of capital assets under Section 208, Revenue Act of 1924. The Commissioner treated it as income taxable at the ordinary rates. (R. 9.) The Board of Tax Appeals held with the Commissioner (R. 18), and the Circuit Court of Appeals reversed the Board (R. 35).

The two oil leases referred to above are set out in full in the record. (R. 25–34.)

SPECIFICATION OF ERRORS TO BE URGED

1. The court below erred in holding that cash bonuses paid as advance royalties for the execution of oil and gas leases in the State of Texas constitute income from the sale of capital assets within the meaning of Section 208 of the Revenue Act of 1924.

2. The court below erred in holding that in determining the questions presented it was bound by the decisions of the Texas courts that leases of oil lands constitute sales of the oil.

3. The court below erred in reversing the decision of the Board of Tax Appeals.

REASONS FOR GRANTING THE WRIT

1. The court below held that the cash bonuses received by respondent were gain from the sale of capital assets and not ordinary income, and followed its earlier decision in *Ferguson* v. *Commissioner,* 45 F. (2d) 573. It concluded that it was bound to reach this result because under the decisions of the highest court of Texas leases of oil lands, such as those involved in this case, are regarded as sales of oil in place. The decision of the court below is in conflict with the decision of the Court of Claims in *Hirschi* v. *United States,* 67 C. Cls. 637, certiorari denied, 280 U. S. 576, where a similar cash payment in connection with a lease of oil lands in Texas was regarded as ordinary income taxable at the ordinary rates.

A bonus paid for the execution of an oil and gas lease is advance royalty. *Work* v. *Mosier,* 261 U. S. 352. The conclusion of the court below that royalties are to be treated as proceeds of the sale of capital assets is in conflict with the decisions of this Court in *Stratton's Independence* v. *Howbert,* 231 U. S. 399; *Stanton* v. *Baltic Mining Co.,* 240 U. S. 103, 114; *Von Baumbach* v. *Sargent Land Co.,* 242 U. S. 503, 521–522; *United States* v. *Biwabik Mining Co.,* 247 U. S. 116, 125–126, and is also in conflict with *Burkett* v. *Commissioner,* 31 F. (2d) 667 (C. C. A. 8th), certiorari denied, 280 U. S. 565; *Berg* v. *Commissioner,* 33 F. (2d) 641 (App. D. C.), certiorari denied, 280 U. S. 598; *Murphy* v. *Commissioner* (App. D. C.), decided February 20, 1930,

without opinion on authority of the *Berg* case, *supra,* 2 Prentice Hall 1930, p. 1963, not otherwise reported; *Reynolds* v. *Commissioner* (App. D. C.), decided February 20, 1930, without opinion upon the authority of the *Berg* case, *supra,* 2 Prentice Hall 1930, p. 1963, not otherwise reported; and *Alexander* v. *King,* 46 F. (2d) 235 (C. C. A. 10th), certiorari denied, 283 U. S. 845. None of the cases cited in this paragraph involved the application of peculiar rules of local law.

The fact that under Texas law a lease of oil lands constitutes a sale of the oil is not determinative, and we believe that the court below erred in giving the effect to local law which it did. Realistically viewed in the light of the decisions of this Court and the other authorities, it is submitted that royalties in fact constitute for Federal income tax purposes a form of rental which is ordinary income rather than gain from the sale of capital assets. The only purpose of the capital gain provisions of the statute was to classify income so that gain from the sale or exchange of capital assets would receive preferential treatment over ordinary income where the amount involved was large enough to reach into the higher tax brackets. There is nothing in the statute which indicates that it was the intention of Congress that peculiar local rules should govern the classification, as was the case in *United States* v. *Cambridge Loan & Bldg. Co.,* 278 U. S. 55, and *Crooks* v. *Harrelson,* 282 U. S. 55. The present case more nearly resembles *Burk-Waggoner Oil Assn.* v.

Hopkins, 269 U. S. 110, and *Weiss* v. *Wiener,* 279 U. S. 333. Accordingly we believe that the court below erred in treating the local law as dispositive of the question presented in this case. In giving such undue effect to the local rule the decision of the court below conflicts in principle with *Rosenberger* v. *McCaughn,* 25 F. (2d) 699 (C. C. A. 3d), certiorari denied, 278 U. S. 604, and *Bankers Pocahontas Coal Co.* v. *Commissioner* (C. C. A. 4th), decided January 25, 1932, not yet reported, III C. C. H. 1932, p. 8234.

2. The questions presented are of general importance, for they affect every oil lease on lands in the State of Texas in connection with which a bonus is paid. As Texas contains the largest oil-producing fields in the United States, a large number of similar cases are necessarily involved, some of which are already pending before the Board of Tax Appeals and in the Bureau of Internal Revenue. A decision by this Court is necessary for the proper administration of the applicable provisions of the several Revenue Acts.

In view of the conflicts of decisions mentioned and the importance of the questions in the administration of the Federal revenue, it is respectfully submitted that the petition should be granted.

THOMAS D. THACHER,
Solicitor General.

MARCH, 1932.

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